# CASE COMMENTARIES

## AGENCY

**In determining whether an individual is an employee or an independent contractor, Tennessee courts will afford greater deference to the parties' conduct than to a contractual designation.** *Teksystems, Inc. v. Farr*, No. M2008-01909-COA-R3-CV, 2009 Tenn. App. LEXIS 207, 2009 WL 1312835 (Tenn. Ct. App. May 11, 2009).

By Amanda E. Nichols

Classification of an individual as an independent contractor or an agent has significant legal implications for companies. In *Teksystems, Inc. v. Farr*, the Tennessee Court of Appeals addressed whether individuals constituted independent contractors or agents, for tax exemption purposes, where a company's service contracts referred to such individuals as independent contractors, but the contracting companies treated the individuals as agents. The court found that the companies' conduct regarding the individuals was more indicative of the individuals' actual classification than the contractual categorization, and the court thus deferred to the companies' conduct.

Teksystems, Inc. ("Teksystems") and Maxim Group, Inc. ("Maxim") are temporary staffing agencies specializing in information technology personnel. Maxim merged with Teksystems, and Teksystems, as successor-in-interest, filed this suit. However, Maxim is the subject of this case. Maxim provided personnel to clients to assist with information technology projects when the clients lacked sufficient staff or the capability to complete the projects. When a client company hired Maxim's employees for a project, the client and Maxim executed a "Professional Service Agreement." Maxim's Professional Service Agreement provided that Maxim would function as an independent contractor while rendering its services; the contract specifically disclaimed any agency relationship between Maxim's employees and the client company.

Upon hiring Maxim's employees, a client company did not simply give the employees an objective and then leave them complete discretion to design and execute a course of action. Rather, the client provided Maxim's employees with both

an objective and the client's own recommendation for its achievement. Thereafter, the client would supervise the performance of Maxim's employees on their assignments. As part of its responsibilities, a client company documented and approved the employees' hours, sick leave, and vacation time. While performing services for the client, Maxim's employees were subject to the same employment policies and company practices as regular employees of the client company. The client required that Maxim's employees observe the client company's dress code and code of conduct. Furthermore, Maxim's employees frequently interacted with regular employees of the client company, working in teams on projects and attending company employee meetings. While Maxim's employees carried out their work for the client, Maxim remained "solely responsible for payroll, withholding, employment taxes, and workers' compensation insurance."

This lawsuit arose when the Commissioner of Revenue (the "Commissioner") classified Maxim as an independent contractor—a classification that resulted in an approximately $2.36 million tax assessment by the Tennessee Department of Revenue. Under the Retailers' Sales Tax Act (the "Act"), the state of Tennessee may tax the sale and use of tangible personal property in Tennessee. The Act includes computer software as tangible personal property, and it categorizes the transfer of software as a sale of software.

However, the Act contains an exemption for any entity that designs software for its private use. Classification as an independent contractor or agent is important for the purpose of this "in-house exemption." The Commissioner, relying upon the language in Maxim's Professional Service Agreement, classified Maxim as an independent contractor. The Commissioner argued that Maxim's employees were performing their services, which involved the transfer of software, to the clients as *outside* assistance. Therefore, the Commissioner argued that Maxim was subject to the sales tax.

In response, Teksystems argued that Maxim's employees were acting as the clients' agents. Teksystems emphasized how the clients were directly responsible for assigning projects to Maxim's employees and supervising their work. Consequently, Teksystems argued that the employees, as agents of the clients, were actually designing software for their own use when completing the clients' projects. Therefore, Teksystems concluded that Maxim should have been tax-exempt by virtue of the "in-house" exception to the Act. The trial court agreed with Teksystems and granted its motion for summary judgment.

On appeal, the Tennessee Court of Appeals affirmed the lower court, finding that Maxim's employees were agents of the client companies and thus exempting Maxim from the sales tax requirement. When determining whether an individual is an independent contractor or an agent, Tennessee courts evaluate the degree of the principal's control over its subordinates based on a totality of the circumstances. As the degree of control that a principal exercises over its subordinates increases, the likelihood increases that the court will find that the subordinates were agents of the principal. If the principal adopts a "hands-off" approach to controlling his or her subordinates, the court will likely find that the subordinates are independent contractors.

As part of the totality of the circumstances, courts examine the principal's attitude toward controlling a project's results. A subordinate likely qualifies as an independent contractor if the principal indicates its desired outcome for a project but leaves the subordinate significant discretion to realize that outcome. On the other hand, when a principal takes a significant interest in both a project's outcome and its means of achievement, so that it specifically directs the subordinate's actions, the subordinates likely constitute agents.

Based on the totality of the circumstances in this case, the Tennessee Court of Appeals declined to give complete deference to the language of the Professional Service Agreement designating the individuals as independent contractors. Instead, the court evaluated the parties' behavior and determined that such behavior more closely resembled the type of conduct in an agency relationship. The court justified its conclusion based on the fact that client companies did not provide Maxim's employees with their desired project objectives without any significant oversight, as is typical in independent contractor relationships. Instead, the client companies told Maxim's employees what software capabilities they wanted and directed how the project's personnel were going to meet those specifications. Moreover, clients treated Maxim's employees as they would treat their own employees. They supervised the employees' performance, tracked their hours and absences, and even oversaw that the employees complied with company policies. Based on the clients' course of conduct, the court found that Maxim's employees were acting as agents of the clients when providing their service. Thus, the court concluded that Maxim was tax-exempt under the Act.

The Tennessee Court of Appeals' decision in *Teksystems* offers essential insight into how a court assesses the totality of the circumstances when determining whether an individual is an agent or independent contractor. Attorneys must

understand that they cannot rely upon contract language to be dispositive of an individual's classification; rather, the court will look to the parties' actual conduct. In particular, the court will closely examine how much control a principal exercises over its subordinates and how involved the principal becomes in executing a task.

When drafting service contracts such as Maxim's, attorneys should clearly delineate the parties' responsibilities regarding the personnel that are the subject of the contract. Once attorneys have drafted such contracts, they must then advise their clients to act in strict accordance with the contract terms. If the attorneys' clients allow their conduct to vary from what the parties have specified in the contract, they could risk reclassification. In this case, classification as an independent contractor or agent was relevant for the purpose of taxation, but the court's reasoning can also have considerable applicability to cases involving vicarious tort liability.

## BANKRUPTCY

**In bankruptcy proceedings, debtors may plan for an asset sale free and clear of liens, without allowing secured lenders the right to credit bid, as long as the sale provides the lenders with an "indubitable equivalent" of their secured interest.** *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

By Nathaniel Dallas

Section 1129(b) of the Bankruptcy Code provides ways in which a debtor's reorganization plan may be "crammed down" the throats of objecting secured lenders; however, the statute also requires that such plans be "fair and equitable" with regards to the proposed treatment of secured claims. Section 1129(b)(2)(A) of the Bankruptcy Code lists three circumstances under which a proposed treatment of secured claims will be considered "fair and equitable." One circumstance permits a debtor to sell its assets free and clear of liens if secured lenders are also allowed to bid their credit. A second circumstance permits reorganization plans that provide secured lenders with an "indubitable equivalent" of their secured interest. In *In re Philadelphia Newspapers,* the United States Court of Appeals for the Third Circuit addressed whether the statutory language of section 1129(b)(2)(A) permitted a debtor to sell its assets free and clear of liens *without* allowing secured lenders to bid their credit.

In this case, Philadelphia Newspapers LLC (the "Debtors") owned and operated two newspapers and an online publication. The Debtors acquired these assets for $515 million, of which $295 million came from a consortium of lenders (the "Lenders"). At the time of the case, the present value of the loan from the Lenders was approximately $318 million. The Debtors subsequently defaulted on the loan and filed a joint Chapter 11 reorganization plan (the "Plan") in which they provided that all of the Debtors' assets would be sold at auction free and clear of liens. The Plan would generate approximately $37 million in cash for the Lenders as well as give them the Debtors' Philadelphia headquarters, valued at $29.5 million and subject to a two-year rent-free lease. The Debtors sought, as part of their motion for approval of bid procedures, to preclude the Lenders from credit bidding. In support of this contention, the Debtors argued that the Plan sale was being conducted under sections 1123(a) and 1123(b) of the Bankruptcy Code, not section 363. Thus, the Debtors argued that the Lenders were not entitled to a credit bid pursuant to section 363(k) of the Bankruptcy Code.

In response, the United States Bankruptcy Court issued an order refusing to allow the Plan to proceed without allowing the Lenders to credit bid. The court determined that any sale of the Debtors' assets required that a secured lender be allowed to credit bid. The United States District Court, however, reversed the bankruptcy court and relied on a plain language interpretation of section 1129(b)(2)(A) of the Bankruptcy Code.

On appeal, the United States Court of Appeals for the Third Circuit exercised plenary review and upheld the Debtors' Plan to conduct an asset sale free and clear of liens without allowing the Lenders to credit bid. Because section 1123(a)(5)(D) provides no explicit procedures for the sale of assets, the court looked to section 1129 to determine what requirements would later have to be satisfied to confirm the Plan. Section 1129(b)(1) of the Bankruptcy Code requires the proposed treatment of a secured lender's claims to be "fair and equitable." Section 1129(b)(2)(A) provides three circumstances under which a reorganization plan is "fair and equitable": subsection (i) permits a sale of assets with the retention of liens and deferred cash payments; subsection (ii) permits a sale of assets free and clear of liens but subject to credit bidding; and subsection (iii), a catch-all provision, states that a plan is "fair and equitable" as long as it provides the secured lender with an "indubitable equivalent" of the lender's secured interest.

In support of their contention to allow credit bidding, the Lenders made three arguments before the court. First, the Lenders argued that a plain reading of

section 1129(b)(2)(A), along with the applicable canons of statutory interpretation, required all asset sales free and clear of liens to fall under subsection (ii). Second, the Lenders argued that the "indubitable equivalent" language of subsection (iii) was ambiguous, and in as much, courts should look to other provisions of the Bankruptcy Code. Finally, the Lenders argued that denying them the right to credit bid was inconsistent with the other provisions of the Bankruptcy Code.

In response to the Lenders' first argument, the court noted that the statute used the disjunctive "or" and thus provided three alternate paths a debtor could take to meet the "fair and equitable" test of section 1129(b)(2)(A). The court also took into account the traditional canon of statutory interpretation, which favors specific statutory provisions over more general statutory provisions. The court, however, stated that this canon would only apply if the more specific provision clearly placed a limitation on the more general provision. In this case, the court found that subsection (ii) did not place a limitation on subsection (iii) because the three options were to be treated as distinct alternatives. The court relied heavily on the Supreme Court's decision in *Varity Corp. v. Howe*, 516 U.S. 489 (1996), where the Court held that a "catchall" phrase does not require use of the more specific provision. Accordingly, the court concluded that subsection (iii) was not limited by subsection (ii).

Next, the court reviewed the Lenders' second argument and determined that the "indubitable equivalent" language unambiguously excluded the right to credit bid. It is important to note that the court was not asked whether the "indubitable equivalent" standard would be satisfied by the sale but was instead requested to interpret the requirements of section 1129(b)(2)(A). Accordingly, the court stated that, since subsection (iii) created no reference to credit bidding, Congress had not afforded lenders the right to credit bid under subsection (iii). The court also noted that, while credit bidding might be a good way to achieve the "indubitable equivalent" standard, it is not required. Taking this into account, the court concluded that it was not in the position to determine whether the Plan would ultimately produce an "indubitable equivalent" absent credit bidding.

Addressing the Lenders' third argument, the court stated that the plain meaning of section 1129(b)(2)(A) was not inconsistent with congressional intent. The court also reasoned that, because the language was not ambiguous, there was no need to look to congressional intent. Although the court acknowledged a narrow exception to the plain meaning rule, where the result would be at odds with the intentions of the drafters, the court determined that the exception was not applicable

in this case. The court also noted that section 363(k) of the Bankruptcy Code allowed assets to be sold free and clear of liens without providing secured lenders the right to bid credit. Thus, the court reasoned that the drafters of the statute had already imagined situations where debtors could sell assets free and clear of liens without giving lenders a right to credit bid. As such, the court held that section 1129(b)(2)(A) was unambiguous and that a plain reading of its provisions allowed the Debtors to proceed under subsection (iii) without allowing the Lenders the right to credit bid.

The Third Circuit's decision in *Philadelphia Newspapers* clarifies the position federal courts will take when interpreting section 1129(b)(2)(A) of the Bankruptcy Code. Since the language of section 1129(b)(2)(A) is unambiguous, a plain reading of its provisions will allow a debtor to proceed under subsection (iii) without allowing lenders to credit bid. It is important to note, however, that the court did not hold that all plans conducted under subsection (iii) preclude credit bidding; rather, the court determined that plans conducted under subsection (iii) will not automatically give lenders the right to credit bid.

In light of this decision, bankruptcy attorneys should be aware that, if a reorganization plan provides the secured lender with an "indubitable equivalent" of its secured interest, an asset sale free and clear of liens may be "fair and equitable" even though credit bidding is precluded. This means that secured lenders may not be able to bring a claim until after the asset sale, because only then will it be known if the sale created an "indubitable equivalent." Bankruptcy attorneys should also note that this opinion speaks to how federal courts will interpret other aspects of the Bankruptcy Code. The opinion suggests that a court will defer to the plain meaning of the Bankruptcy Code using the canons of statutory interpretation, such as those applied in this case.

**In Tennessee, where goods are consigned to a merchant and the merchant declares or is forced into bankruptcy, such goods are not subject to attachment by the merchant's creditors.** *In re Music City RV, LLC*, 304 S.W.3d 806 (Tenn. 2010).

By Cashauna C. Lattimore

A consignment is a transaction where the owner of goods delivers possession of those goods to a bailee who is also given the authority to sell the goods to its

customers. However, title to the goods remains with the consignor until the goods are sold to the ultimate buyer. The consignee is free to return any unsold goods to the consignor. The Tennessee Supreme Court, in *In re Music City RV, LLC*, was confronted with whether a consumer's consignment of recreational vehicles ("RVs") to a Tennessee RV dealer was covered under section 47-2-326 of Tennessee's Uniform Commercial Code (the "UCC"), which governs the sale, return, and consignment of goods. The court held that the UCC did not apply to the consignment because the statute was amended to exclude consignments from its coverage.

The relevant facts of this case began when Dudley King and eight others (the "Consigners") consigned their RVs to Music City RV, LLC ("Music City"). Shortly after the consignment, Music City's creditors initiated an involuntary Chapter 7 bankruptcy action against Music City in the United States Bankruptcy Court for the Middle District of Tennessee. The issue before the Bankruptcy court was whether the consigned RVs were property of the Music City estate and, therefore, were available to Music City's creditors for attachment. For some guidance, the bankruptcy court certified the following question of law to the Tennessee Supreme Court: "Whether the consignment of an [RV] by a consumer (not another business) to a Tennessee [RV] dealer, for the purpose of selling that [RV] to a third person, is a transaction covered under [section] 47-2-326 of [the UCC], as adopted by Tennessee."

The Tennessee Supreme Court deemed this an issue of statutory interpretation. It considered the 2001 revision of section 47-2-326 of the Tennessee Code, which entirely deleted subsection (3) of the statute. That subsection provided that when goods are delivered to a person for sale and that person has a business where he or she deals in the same kinds of goods as the ones delivered, the goods are deemed to be on sale or return, even if the agreement between the parties contains words such as "on consignment" or "on memorandum." The subsection also stipulated that goods, deemed to be on sale or return, are subject to creditors' claims while still in the buyer's possession.

Both parties, the Consignors and the Bankruptcy Trustee, agreed that under the earlier version of the statute, the consigned RVs would have been held on "sale or return" and thus, would have been included in the bankruptcy estate and subject to creditors' claims. However, on July 1, 2001, the Tennessee General Assembly amended section 47-2-326 and deleted subsection (3) entirely.

The Consigners argued that the amended statute removed all consignments from coverage under Article 2 of the UCC. The court considered whether Article 9, dealing with Secured Transactions, would apply. However, the parties again conceded that Article 9 was not applicable because Article 9 only applied to consignments of goods that were not consumer goods. The RVs were classified as consumer goods, which are defined by section 47-9-102(a)(23) of the Tennessee Code as "goods that are used or bought for use primarily for personal, family, or household purposes." Thus, because consignments were not included in Article 2 or in Article 9, the Creditors argued that the consignments were now governed by the common law of bailments.

The Tennessee Supreme Court agreed with the Consignors' interpretation of the law and held that the RVs were not property of the bankruptcy estate. The court first noted that the amended version of the statute did not contain any reference to "consignments" or any type of transaction that would have qualified as a consignment. When goods are consigned, title to the those goods remains with the consignor until the ultimate buyer has purchased the goods, and the court found that there was no evidence in the record that would suggests that title to the RVs did not remain with the Consignors.

The court also noted that the statute expressly applied to situations where "delivered goods may be returned by the buyer even though they conform to the contract." Because the statute expressly referred to buyers, the court found that the statute was not applicable to the RVs, which were assigned to Music City, rather than purchased. Although section 47-2-103(1) of the Tennessee Code defines "buyer" as "a person who buys or contracts to buy goods," the court reasoned that Music City's relationship with the Consignors was a consignment relationship. In making this determination, the court found that Music City agreed to take possession and sell the RVs for a commission. Because Music City was not a buyer, the court concluded that section 47-2-326 of the Tennessee Code did not apply and that the RVs were not part of the bankruptcy estate.

This decision presents a unique situation for attorneys involved in bankruptcy proceedings. The court makes it clear that goods consigned by a consumer to a merchant are not covered by section 47-2-326 of the Tennessee Code, meaning that those goods are not subject to the attachment of creditors in a bankruptcy proceeding. Consumers in Tennessee who consign their goods to dealers can take comfort in the fact that the dealers' creditors will not be able to attach their consigned goods. However, it creates an additional burden on creditors'

rights attorneys. These parties will now have to determine how each item in the bankruptcy estate was acquired by the debtor entity. If, as in this case, the item was acquired by consignment, it is not available for attachment by the creditor.

## BUSINESS ASSOCIATIONS

**An investment advisor's compensation violates a fiduciary duty under section 36(b) of the Investment Company Act of 1940 when that compensation bears no reasonable relationship to the services rendered and could not have been a product of arm's-length bargaining.** *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010).

By Michael Franz

In a series of 1970 amendments to the Investment Company Act of 1940 (the "Act"), Congress sought to address growing concerns about the rights of investment company shareholders to protect their investments from abuse by fund managers and advisors. Specifically, an amendment to Section 36(b) of the Act, now codified as 15 U.S.C. § 80a-35(b), imposed a "fiduciary duty" on an investment company's managers with respect to compensation. The amendment also provided shareholders with the legal means to challenge potentially excessive compensation in the federal courts. In *Jones v. Harris Associates L.P.*, the United States Supreme Court addressed the competing standards that had been used by federal courts to determine whether an investment company had violated its "fiduciary duty" under section 36(b)(1) of the Act by charging excessive management fees.

In *Harris Associates*, Jones and other investors ("plaintiffs") owned shares in three different mutual funds, all managed by Harris Associates L.P. ("Harris"). Plaintiffs brought an action, solely under section 36(b) of the Act, against Harris in the United States District Court for the Northern District of Illinois, claiming that Harris's compensation was so excessive that it violated the fiduciary duty to shareholders under the provisions of the Act as amended in 1970.

The district court, finding no Seventh Circuit case on the issue, chose to adopt the standard set forth by the Second Circuit in a case with facts similar to *Harris Associates*. In *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), the Second Circuit held that, in order for a plaintiff to succeed in an action against an investment advisor for excessive compensation under section 36(b),

the compensation must be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." The *Gartenberg* court also specifically rejected a standard of "reasonableness" for assessing whether the compensation amounted to a breach of fiduciary duty.

The district court in *Harris Associates* adopted the *Gartenberg* standard, found that the fees charged by Harris fell within an accepted range given all the circumstances, and granted summary judgment for Harris. On appeal, the United States Court of Appeals for the Seventh Circuit affirmed the order of summary judgment but explicitly rejected the district court's adoption of the *Gartenberg* standard. Instead, the Seventh Circuit insisted that the "fiduciary duty" in the statute requires only that the investment manager or advisor negotiate for compensation openly, honestly, and without deceit. Under this approach, market forces, rather than the courts, would determine the actual amount of compensation. Absent a showing of some type of unfair dealing, rates of compensation, however excessive they might seem, would not be challengeable under section 36(b) of the Act.

On appeal and in response to the circuit split generated by the Seventh Circuit's holding, the United States Supreme Court granted certiorari and held that the *Gartenberg* standard is in fact the appropriate method to determine whether excessive compensation violates an investment advisor's fiduciary duty to the shareholders. The Court preferred the *Gartenberg* approach to the Seventh Circuit's market-based approach primarily because prior Supreme Court cases had utilized a standard equivalent to that of *Gartenberg* when considering the term "fiduciary duty" in similar contexts such as bankruptcy law. Also, the Court pointed out that the *Gartenberg* standard, by allowing courts to reject fees only if they are so large that they could not have been a product of arm's-length bargaining, best preserves the entire Act's "statutory scheme" and its focus on deference to impartial and knowledgeable investment fund boards on issues of compensation. A *Gartenberg* interpretation of the fiduciary duty in section 36(b) of the Act would allow shareholder suits and reviews by mutual fund boards to act as "mutually reinforcing but independent mechanisms for controlling conflicts" and would avoid giving complete deference to the boards.

Next, because the parties disputed how a *Gartenberg* standard would actually function under section 36(b) of the Act, the Court clarified two additional points. First, the Court held that lower courts may, for the purpose of assessing whether compensation reasonably reflects the advisor's services, compare disputed fees to

other fees charged by the same investment company for the management of other clients' funds, so long as those courts are "wary of inapt comparisons." The Court also cautioned against the use of comparisons to fees charged by other investment companies and advisors because those fees might themselves not meet the *Gartenberg* standard. Although the *Gartenberg* court had excluded certain types of fee comparisons, the *Harris Associates* court chose to permit those comparisons, when appropriate, as one aspect of "all relevant circumstances" to be taken into account when deciding whether fees could have been a product of arm's-length bargaining.

Second, the Court reiterated that trial courts must respect the intent of the Act and afford deference to the role of mutual fund boards as "independent watchdogs" with respect to compensation. The level of deference should itself depend on all relevant circumstances, and greater deference should be given to boards that make informed, open, and honest decisions based on all relevant facts. The Court rejected the Seventh Circuit's approach because it awarded nearly unlimited deference to boards as long as those boards complied with full disclosure and exhibited good faith. Vacating the judgment, the Court remanded the case for consideration under the *Gartenberg* standard.

Transactional attorneys advising mutual fund boards and managers should note the open-ended approach to *Gartenberg* taken by the United States Supreme Court in *Harris Associates*. Even though the Court discouraged comparisons to the fees charged by other mutual funds, the "all relevant circumstances" test grants trial courts substantial flexibility in selecting the criteria for assessing fees under *Gartenberg*. As a result, fund managers should at least consider all possible comparisons to other funds before setting compensation rates. Managers and boards should also carefully assess the unique characteristics of each fund that might impact compensation, such as the number and frequency of transactions, the amount of time and effort required to maintain the fund, and the number of shareholders.

Additionally, in order to capture the benefits of the required deference to mutual fund boards, attorneys should direct those boards to keep detailed records of the rate-approval process. If fund advisors can show that a board made a well-reasoned and thorough endorsement of a management fee, courts will be less likely to engage in the "judicial second-guessing of informed board decisions" that is prohibited under *Harris Associates*. Deference to company boards, in combination with the plaintiff's burden of proof, will ensure that many compensation rates are safe from challenges under section 36(b) of the Investment Company Act.

However, attorneys should still be vigilant in anticipating the kinds of comparisons that a court might make in the event that litigation does arise.

Likewise, attorneys representing mutual fund investors should also note the flexibility encouraged by the Court in *Harris Associates*. Decisions on whether to challenge compensation rates should take into account the full range of facts and circumstances involved. Most importantly, attorneys considering litigation should take great care to reach appropriate balance in the use of fee comparisons. Although the holding in *Harris Associates* does not restrict the use of any specific type of comparison to show that compensation is excessive, the Court did insist that those comparisons not be "inapt". If investors decide to compare one investment company's fees to those of another, they should ensure that the two funds are sufficiently similar in all areas to convince a court that the comparison has any real value.

**Under the Petroleum Marketing Practices Act, a petroleum franchisee cannot recover for "constructive" termination if the franchisor's conduct did not compel the franchisee to abandon his franchise, nor can a franchisee maintain a claim for "constructive" nonrenewal if the franchisee signs and operates under a renewal agreement.** *Mac's Shell Serv., Inc. v. Shell Oil Prods. Co.*, 130 S. Ct. 1251 (2010).

By Greer Lynch

When franchisors elect to adjust terms in franchise renewal agreements, franchisees are, arguably, at a disadvantage in bargaining power. Changes substantially detrimental to a franchisee's economic interests could be used to coercively produce disadvantageous terms or relieve the franchisor from obligations under the agreement. The Petroleum Marketing Practices Act ("the PMPA") was specifically enacted to combat these disadvantages, requiring franchisors to meet certain standards before terminating a franchise or declining to renew a franchise agreement. In *Mac's Shell Service, Inc. v. Shell Oil Products Co.*, the United States Supreme Court addressed whether there is a limit to a franchisee's claims of violation of the PMPA, thereby preventing bad-faith claims when a franchisor implements reasonable renewal terms. The Court held that a franchisee cannot recover under the PMPA for "constructive" termination if the franchisor's conduct does not compel the franchisee to abandon its franchise. Additionally, a franchisee that signs

and operates under a renewal agreement may not maintain a claim for "constructive" nonrenewal.

For many years, Shell Oil Company ("Shell"), a petroleum franchisor, participated in service-station franchise agreements in Massachusetts. Under the agreements with Shell, each franchisee paid a required, monthly rent for the use of service-station premises and associated franchise trademarks. A gratuitous benefit by Shell granted a rent subsidy when a franchisee sold above a specified threshold of Shell fuel. This practice ended in 1998 when Shell joined two other companies to create Motiva Enterprises LLC ("Motiva"). Motiva was assigned the rights and obligations of the existing franchise agreements and implemented two changes that led to this lawsuit: Effective January 1, 2000, Motiva ended the volume-based rent subsidy and also used a new formula for calculating rent. Seven of eight service-station dealers approaching expiration signed and operated under the new renewal agreements, which included the altered rent formula and did not include a rent subsidy. The eighth dealer sold his franchise before the original agreement expired.

Following the agreement modifications, sixty-three Shell franchisees ("Dealers") filed suit in United States District Court against Shell and Motiva, claiming both a breach of contract under state law and two federal violations under the PMPA. By elimination of the rent subsidy, the Dealers asserted their franchises were constructively terminated in violation of the PMPA. Additionally under the PMPA, the Dealers claimed that the change in the calculation of rent constituted a constructive nonrenewal of their franchise agreements. The jury found for the Dealers on all claims, including an award for $1.3 million for breach of contract under state law.

On appeal, the First Circuit affirmed the decision of the trial court regarding constructive termination but reversed the trial court's decision on constructive nonrenewal. The circuit court held that a franchisee is not required to abandon the franchise premises to constructively terminate an agreement. Alternatively, they held that a simple breach of contract could end an agreement by constructive termination if the breach results in a material change that effectively ends the lease. As for constructive nonrenewal, the circuit court found that, once a franchisee signs and operates under a contended renewal agreement, he can no longer maintain a claim for violation of the PMPA through constructive nonrenewal. Shell subsequently appealed to the United States Supreme Court. Certiorari was granted.

The United States Supreme Court upheld the decision of the First Circuit regarding constructive nonrenewal. However, the Court reversed the First Circuit's decision on constructive termination, holding that "a necessary element of any constructive termination claim . . . is that the franchisor's conduct forced an end" to franchise operations. Basing this decision on the intent of Congress in enacting the PMPA, the Court began by drawing a parallel to legal terms in other fields, referencing both employment and property law. The Court found that, as with constructive discharge and constructive eviction, a consistent requirement for a constructive termination claim is abandonment. Congress presumably intended an analogous legal interpretation, requiring that the plaintiff, rather than the defendant, formally conclude the previous relationship to maintain a "constructive" end. Furthermore, the Court reasoned that meeting the requisite seriousness of breach to effectively end an agreement is unworkable where the breach was not severe enough to compel abandonment. Finally, in enacting the PMPA, the Court determined that Congress regulated only a narrow portion of petroleum operations, leaving all other state regulations intact. The Court concluded that extending the PMPA beyond Congress' intended reach is inconsistent with its limited purpose of prohibiting simple breaches and is an intrusion into a traditionally state domain.

The Court's decision in *Mac's Shell Service* serves as a guide to petroleum franchisors and franchisees in advancing franchise renewal terms. In the shadow of BP's Deepwater Horizon oil rig explosion and the subsequent uncontrolled oil leak, increased safety procedures and protections against adverse environmental impacts of offshore oil drilling are anticipated. Additional costs to meet increased industry standards will not be borne by franchisors alone; both franchisees and customers will fund operating cost increases. As these necessary cost increases emerge in franchise renewal agreements, franchisees may dispute renewal terms and consider action under the PMPA for a wide range of remedies, from compensatory and punitive damages to equitable relief.

The decision in *Mac's Shell Service* emphasizes limitations on both sides of a petroleum franchise renewal agreement. Transactional attorneys should stress to franchisors the importance of making calculated modifications rather than simply passing additional burdens to franchisees and customers. Attorneys for franchisees should alternately dissuade their clients from frivolous termination and nonrenewal claims where lawful adjustments do not compel abandonment of the franchisor's trademark, fuel, or service station. While the PMPA limits circumstances that permit franchisors to terminate or decline renewal of a franchise agreement, the Supreme

Court's decision in *Mac's Shell Service* correspondingly limits franchisees from invoking the PMPA without first acting on the detrimental effects of unfair renewal terms.

## CIVIL PROCEDURE

**For purposes of diversity jurisdiction, a corporation's "principal place of business" is the corporation's "nerve center," or the place where the corporation's officers direct, control, and coordinate the corporation's activities.** *Hertz Corp. v. Friend*, 130 S. Ct. 1181 (2010).

By Sydney Koch

In an effort to limit out-of-state prejudice, Congress enacted 28 U.S.C. § 1332, which provides that "a corporation shall be deemed to be a citizen of any State by which it has been incorporated and of the State where it has its principal place of business." However, what constituted a corporation's "principal place of business" under § 1332 was unclear until the Supreme Court resolved this issue in *Hertz Corp. v. Friend*. In this case, the Supreme Court unanimously held that a corporation's "principal place of business" is the "place where a corporation's officers direct, control, and coordinate the corporation's activities. . . . [I]n practice it should normally be the place where the corporation maintains its headquarters . . . provided that the headquarters is the actual center of direction, control, and coordination . . . ." In developing this test, the Supreme Court recognized that the "place" to which its holding refers is the company's "nerve center," as described by the court of appeals in its analysis.

In *Hertz*, litigation began when plaintiffs Melinda Friend and John Nhieu (the "respondents"), both California citizens, sued Hertz Corporation ("Hertz") in California state court, claiming damages for alleged violations of California's wage and hour laws. The respondents requested relief for themselves and "on behalf of a potential class" of California citizens. Hertz subsequently sought removal to federal court, claiming that, because it was a citizen of a different state than the respondents, the federal court possessed diversity jurisdiction. The respondents, however, disagreed and argued that diversity jurisdiction was lacking because Hertz was a California citizen. Hertz submitted a declaration stating that its leadership, domestic subsidiaries and corporate headquarters were in New Jersey, and that it carried out its

"core executive and administrative functions" there. Although the United States District Court for the Northern District of California accepted the facts in Hertz's declaration, the district court ultimately concluded that Hertz was a California citizen.

To reach its decision, the district court applied the Ninth Circuit's test, which essentially compared the amount of a corporation's business activity in each state and declared that the state with the most activity was the corporation's "principal place of business." Applying this standard, the district court found that Hertz had more business activity in California than in any other state, thus establishing California as Hertz's "principal place of business" and confirming that Hertz was a California citizen. As a result, diversity jurisdiction was destroyed. The district court remanded the case to state court, but Hertz appealed. The United States Court of Appeals for the Ninth Circuit then affirmed the district court's decision, and Hertz filed a petition for certiorari. On review, the Supreme Court acknowledged the differences between the circuits regarding this issue and, recognizing a need for uniformity, granted certiorari.

To understand the Supreme Court's analysis, it is important to first understand the statutory basis for its ruling and the various tests that the statutes inspired. Under § 1332, a corporation is a citizen of the state where it has its "principal place of business." So long as the amount in controversy exceeds $75,000, and the dispute is between parties who are citizens of different states, the federal district courts have original jurisdiction. Additionally, 28 U.S.C. § 1441 allows cases that are brought in state court and meet § 1332's requirements to be removed to federal court.

Prior to *Hertz*, each circuit court applied § 1332 differently. The First Circuit applied either a "center of corporate activity" test or a "locus of operations" test that utilized several general factors regarding business practices. The Second, Fifth, Ninth and Eleventh Circuits employed similar two-part tests that first determined whether "a corporation's activities are centralized or decentralized" and then applied a "nerve center" or "place of operations" test similar to the Third Circuit's "headquarters of day-to-day activities" analysis. In contrast, the Tenth Circuit considered the activity of the entire corporation, and the Fourth Circuit did not endorse one test over another. The factors that each circuit examined were similar and overlapped in many instances, but there was no consensus of what constituted a corporation's "principal place of business" for purposes of citizenship and diversity jurisdiction.

In developing a test to determine what constitutes a corporation's "principal place of business," the Supreme Court considered the circuit courts' tests and ultimately found three reasons to establish the test adopted in *Hertz*. First, the Supreme Court examined the language of § 1332 and held that the statute's language supported the "nerve center" approach. The Supreme Court noted that the word "place" represented a single location and that the "place" must be the "principal" place, meaning the most prominent, leading location of the corporation. Also, the Court concluded that the statute deemed a corporation a citizen of the "state where it has its principal place of business," implying that the place is *within* the state and is not the actual state itself. This excludes an approach that would allow a state to be the primary place of business by virtue of having the most business by volume, which may merely reflect the size of a state's population instead of the scope of corporate activity.

Second, the Supreme Court acknowledged the importance of administrative simplicity and noted that a complex test would hinder a court's ability to litigate a case efficiently. The Court reasoned that the more complicated the test, the more time and money parties would devote to jurisdictional disputes instead of the claim's merits. Similarly, the Court found that an easy rule would simplify cases, make outcomes more predictable, and as a result, better equip corporations to make sound business and investment decisions. Of the approaches considered, the Supreme Court held that the "nerve center" approach was most simple to apply.

Finally, the Supreme Court examined § 1332's legislative history. The legislative history indicated a preference for a simple test and suggested using a numerical test that used a corporation's gross income to determine its "principal place of business." While the numerical test was not accepted, the Supreme Court held that the test applied should be no more complex than the numerical test. The Supreme Court again determined that the "nerve center" test best achieved that goal.

Applying the "nerve center" test, the Supreme Court found that the declaration presented by Hertz indicated a "principal place of business" in New Jersey. According to the test, a corporation's "principal place of business" is its "nerve center," which is the place where officers conduct and control the corporation's activities. Because Hertz's main executive and important administrative functions were carried out at its corporate headquarters in New Jersey, the Court determined that that test indicated Hertz's "principal place of business" was also in New Jersey. In light of this finding, however, the Court ultimately held

that the respondents "should have a fair opportunity to litigate their case," vacated the Ninth Circuit's judgment, and remanded the case for further proceedings.

The Supreme Court's decision in *Hertz* dictates a uniform test, finally settling the differences between circuits in determining a corporation's "principal place of business." No prior holding had clarified what businesses or attorneys might expect regarding this important jurisdictional question. Now, however, corporations will be better able to predict the state in which they will be considered a citizen, and hence will be better able to predict which courts may invoke jurisdiction over them. Knowing what to expect will also allow corporations to make sound business and investment decisions.

In addition, applying a uniform test will simplify jurisdictional disputes and will save corporations, attorneys, courts and consumers time and money. National corporations that may have argued jurisdictional disputes differently in separate locales can now depend on one, uniform test. As a result, jurisdictional disputes may now be settled more efficiently. Because the outcome will be easier to anticipate under one test than under multiple tests, these disputes may also be more easily avoided. However, when such disputes do arise, analyzing the issues under one, clear test will take less time and will be less costly. Transactional attorneys representing multi-state corporations should inform their clients about the standards of the "nerve center" test and explain that such a test is applicable throughout the United States. Failure to do so could result in a corporation wasting time and money on superfluous jurisdictional issues.

**In Tennessee, service of process on a defendant corporation's attorney, but not the actual corporation, fails to invoke the trial court's jurisdiction, and any orders handed down by the trial court will not be binding.** *Proffitt v. Smoky Mountain Woodcarvers Supply, Inc.,* No. E2009-00667-COA-CV, 2010 Tenn. App. LEXIS 234, 2010 WL 1240975 (Tenn. Ct. App. Mar. 31, 2010).

By N. Adam Dietrich II

For a court in Tennessee to acquire in personam jurisdiction over a defendant, it is essential that the defendant be properly served with process pursuant to Rule 4 of the Tennessee Rules of Civil Procedure. In *Proffitt v. Smoky Mountain Woodcarvers Supply, Inc.*, the Tennessee Court of Appeals addressed the issue of whether a trial court has the authority to enter orders against a defendant who had

actual or constructive notice of the complaint, yet had not been properly served with process. Specifically, the court looked at the issue in the context of section 48-26-104 of the Tennessee Code, which permits trial courts to summarily order a corporation to allow a requesting shareholder to copy and inspect its business records. Concluding that the statute was not an exception to the well-settled principle of law requiring notice by service of process, the court held that the corporate defendant was never a party before the court; therefore, the trial court did not have the authority to order the defendant to comply with the request to copy and inspect its business records.

On August 4, 2008, the attorney for Beth Proffitt (the "Plaintiff") sent a letter on behalf of his client to counsel for Smoky Mountain Woodcarvers Supply, Inc. (the "Defendant") requesting "all business records that are in existence . . . ." The Defendant itself was not sent a copy of the letter. Although the letter did not directly mention the statute, the letter purported to be a request under section 48-26-102 of the Tennessee Code, which provides that "[a] shareholder of a corporation is entitled to inspect and copy" certain business records, including the minutes of corporate meetings, accounting records, and the record of shareholders. However, the Plaintiff's letter failed to state "with reasonable particularity the shareholder's purpose and the records the shareholder desire[d] to inspect," as required by section 48-26-102. When the Defendant failed to respond, the Plaintiff filed a complaint pursuant to section 48-26-104 requesting the trial court to summarily order the Defendant to allow her to inspect its business records and to award her costs and reasonable attorney fees. The Defendant never received a summons or a copy of the complaint. Thereafter, the Plaintiff filed a motion to set a trial date, but once again, neither a summons nor a complaint was served on the Defendant.

After receiving an ex parte order from the court setting a trial date, the Defendant "appeared specially to file a motion to dismiss asserting lack of jurisdiction over the person, insufficiency of process, and insufficiency of service of process." Without discussing the sufficiency of the Plaintiff's letter requesting inspection of corporate documents under section 48-26-102, the trial court found that the Plaintiff's "Petition" to the court constituted an application in accordance with section 48-26-104. According to the court, because the Plaintiff complied with the requirements of the statute, it did not matter whether the Defendant had been served with process. Further, because the Defendant's attorney had received copies of the complaint, the Defendant had actual or constructive knowledge of the Plaintiff's request; as a result, the Defendant was required to allow the Plaintiff to

inspect its business records, as well as pay the Plaintiff reasonable costs and attorney fees.

Next, the Defendant filed motions "to stay proceedings to enforce the judgment, to alter or amend the judgment," and to challenge the constitutionality of the Tennessee corporate records statutes. In March 2009, the trial court denied the Defendant's motions and awarded the Plaintiff additional costs and attorney fees. Reviewing the trial court's decision de novo, the Tennessee Court of Appeals reversed, holding that because the Defendant was never served with process, the trial court lacked in personam jurisdiction over the Defendant, and therefore, the orders it entered were void.

On appeal, the Plaintiff asserted that because she held a 25% interest in the Defendant corporation, it was her legal right to review and copy its business records. Mirroring the belief of the trial court, she also contended that the Defendant had actual or constructive notice of the complaint. The Defendant, on the other hand, argued that the trial court lacked in personam jurisdiction over it because the Plaintiff failed to adhere to Rule 4 of the Tennessee Rules of Civil Procedure in regards to the service of process. Additionally, the Defendant asserted that "it defies logic and due process that an unserved 'petition' can be acted upon 'summarily' without an opportunity to defend when the law provides for an answer to a complaint."

Finding merit in the Defendant's arguments, the appellate court considered its previous decision in *Watson v. Garza*, 316 S.W.3d 589 (Tenn. Ct. App. 2008), where it held that "[b]ecause the trial court's jurisdiction of the parties is acquired by service of process, proper service of process is an essential step in a proceeding." Taking this point a step further, the court then considered what is meant by "proper service of process." The court reasoned that because the Tennessee Rules of Civil Procedure are given the "full force and effect" of the law, service of process must strictly comply with Rule 4. According to the court, nowhere in Rule 4 or in supporting case law does it say that "second hand" or "passed along" service of process is proper. Therefore, even though the Defendant might have had actual or constructive notice of the complaint, the court concluded that Defendant was not served in accordance with Rule 4.

In sum, the appellate court was not required to take into account the constitutionality of section 48-26-104 of the Tennessee Code in ultimately reversing the trial court's ruling in favor of the Plaintiff. Rather, it relied on prior decisions in

reaffirming that "[i]f a defendant is not before the court either by service of process or by the entry of an appearance, a judgment is void and subject to attack." According to the court, the defenses listed in Rule 12 of the Tennessee Rules of Civil Procedure, regarding jurisdiction and process, are useless if trial courts can issue orders without the Defendant having ever received notice. Therefore, the logical conclusion is that because the Defendants were not served pursuant to Rule 4, they were not before the court, and thus, the order directing them to allow the Plaintiff to review and copy their business records was void.

In practice, corporate litigators should interpret the holding in *Proffitt* as a clear indication that they should always ensure proper service of process on defendants in order to eliminate the possibility of reversal on appeal. Just because the defendant had actual or constructive knowledge of the complaint, does not mean that proper service of process was effectuated. As a result, when seeking recovery against a corporate defendant, it will not be sufficient to merely serve process on counsel for the corporation.

Moreover, for attorneys representing defendant corporations, insufficient service of process can be used as a tool for quickly dismissing unfavorable matters facing clients. Should a plaintiff attempt service of process on a corporate defendant through its attorney, that attorney should inform the plaintiff that she cannot accept service for the corporation. If the plaintiff again fails to serve process on the registered agent of the corporation, the attorney for the defendant corporation may file a motion to dismiss asserting lack of jurisdiction over the person, insufficiency of process, and insufficiency of service of process. Honoring the decision in *Proffitt*, as well as a defendant's constitutional right to present a defense, the court will likely dismiss the action in favor of the corporate defendant.

Finally, when representing corporate shareholders, attorneys must not overlook the necessity of serving process on the corporation under Rule 4 of the Tennessee Rules of Civil Procedure. In those situations, the decision in *Proffitt* makes it clear that simply complying with the requirements of section 48-26-102 and filing a petition with the court is not enough to obtain the order. Not only will this decision make it more difficult for a shareholder to obtain access to a corporation's business records, but it could also have the effect of diminishing the transparency of the corporation by making these efforts more costly to pursue.

## CONTRACTS

**Recorded mortgages provide constructive notice to bona fide purchasers, despite deficiencies in the acknowledging notary's appointment, if the notary acts under apparent authority.** *Rogan v. New S. Fed. Sav. Bank (In re Pelfrey)*, 419 B.R. 10 (B.A.P. 6th Cir. 2009).

By Scott M. McLeod

As a bona fide purchaser of a bankruptcy debtor's real property, a bankruptcy trustee can void a debtor's mortgage if the mortgage is voidable under state law. For example, mortgages that are not properly recorded are voidable by subsequent bona fide purchasers in some states. To properly record a mortgage, a lawfully appointed notary public must witness and acknowledge the mortgagor's signature granting the mortgage. Kentucky and states with similar statues require that lawfully appointed notaries take an oath of office and provide a notarized surety bond. In *Rogan v. New South Federal Savings Bank*, the Sixth Circuit Bankruptcy Appellate Panel addressed whether a Chapter 7 bankruptcy trustee could void a debtor's mortgage due to the fact that the mortgage was acknowledged by a notary who had allegedly not fulfilled the requirements necessary to become a lawful notary.

In May 2007, James Pelfrey ("Pelfrey") and his wife granted a mortgage on real estate in Lee County, Kentucky to secure payment on a $152,640 loan. A notary, L. Allyson Honaker ("Honaker"), witnessed and acknowledged the signatures of Pelfrey and his wife on the mortgage, and the mortgage was recorded in the county clerk's office twelve days later. Later, the mortgage was assigned to New South Federal Savings Bank ("New South").

Three months earlier, Honaker had requested that the Madison County Clerk approve her application to become a lawful notary public. In a meeting with her surety and the deputy clerk, Honaker took the oath of office and submitted a bond pledging to lawfully carry out the duties of the office. Both Honaker and her surety signed the bond. As was the practice in the Madison County Clerk's Office, the deputy clerk did not sign Honaker's bond certifying that Honaker took the oath of office. Furthermore, Honaker did not submit the required notarized written statement from her surety guaranteeing that Honaker would properly discharge the duties of a notary.

Fifteen months after granting the mortgage, Pelfrey filed for bankruptcy

under Chapter 7 of the Bankruptcy Code. Pelfrey's appointed bankruptcy trustee subsequently brought an adverse proceeding against New South in which he sought to avoid the Pelfreys' mortgage by alleging that the mortgage was not properly recorded due to the fact that Honaker was not a lawful notary at the time of the recording. The trustee argued that Honaker had not met the requirements of section 423.010 of the Kentucky Revised Statutes, which mandates that before becoming lawful notaries, prospective notaries must take an oath of office and provide a notarized statement from a surety providing security on their promise to properly perform their duties as notaries. The trustee reasoned that because the deputy clerk's signature was not present on Honaker's bond certifying that Honaker took the oath of office and because Honaker did not submit a notarized statement from a surety, Honaker was not a duly appointed notary at the time the mortgage was granted. Accordingly, the trustee asserted that the Pelfreys' mortgage had not been properly recorded because a lawful notary did not witness and acknowledge the Pelfreys' signatures. As a result, the trustee claimed that, as a bona fide purchaser of the Pelfreys' real property, he could avoid the Pelfrey's unrecorded mortgage because unrecorded liens on real property are voidable by bona fide purchasers under state law. Later, the trustee amended his complaint, adding Honaker as a defendant and asking the court to declare void Honaker's acknowledgement of the Pelfreys' signatures on the mortgage.

To refute the trustee's allegations, Honaker submitted an affidavit from the deputy clerk confirming that he had administered the oath to Honaker and an affidavit from the County Clerk stating that the practice of the Madison County Clerk's Office is not to sign the notary's bond. In addition, Honaker provided an affidavit from Honaker's surety stating that he and Honaker both signed the bond and that he witnessed Honaker take and agree to abide by the oath of office. The court noted that the trustee could provide no evidence to contradict these affidavits.

New South responded to the trustee's original complaint by contending that the mortgage had been properly recorded because Honaker was a duly appointed notary, or in the alternative, was a de facto notary under Kentucky law. In response to the amended complaint, New South argued that the trustee could not attack the legitimacy of the notary's acknowledgement because the trustee's claim did not conform to section 61.060 of the Kentucky Revised Statutes, which requires that challenges to a notary's acknowledgement be brought in a direct action against the notary or be based upon either an allegation of fraud or an allegation of mistake by the notary.

The trustee, Honaker, and New South all filed motions for summary judgment. Relying on the Sixth Circuit Bankruptcy Appellate Panel's decision in *Kendrick v. Deutsche Bank National Trust Co. (In re St. Clair)*, 380 B.R. 478 (B.A.P. 6th Cir. 2008), the United States Bankruptcy Court for the Eastern District of Kentucky ruled that Honaker was a de facto notary and granted the defendants' motions for summary judgment.

On appeal, the Sixth Circuit Bankruptcy Appellate Panel also found sufficient support for the conclusion that Honaker was a de facto notary. The court defined de facto notaries as notaries who act under apparent authority even though their appointment may be invalid or uncertain. Kentucky case law instructs that the acknowledgements of notaries whose commissions have expired are valid as long as the contracting parties are not aware the notary's title is not legitimate and have no reason to doubt the legitimacy of the notary's title. Accordingly, the court reasoned that, like de facto notaries who make valid acknowledgements despite expired commissions, Honaker was a de facto notary whose acknowledgement was valid because the Pelfreys were not aware of the possible deficiencies with Honaker's appointment and had no reason to doubt her appointment.

The court next considered whether the trustee could invalidate Honaker's acknowledgement in accordance with section 61.060 of the Kentucky Revised Statutes. Under section 61.060, which applies to notaries under Kentucky case law, an acknowledgement by a notary that appears valid on its face can be challenged only by a direct proceeding against the notary, an allegation of fraud against the notary, or an allegation of mistake on the part of the notary. The trustee contended that he had fulfilled the requirements of section 61.060 by seeking declaratory relief against the notary. However, the court determined that to constitute a direct action under Kentucky case law, a party must seek actual recovery against a notary rather than miscellaneous forms of relief such as the declaratory relief the trustee sought. Furthermore, because Honaker's acknowledgement appeared valid on its face and the trustee made no claim of fraud or mistake against the notary, the trustee's challenge to Honaker's acknowledgement did not conform to the requirements of section 61.060. As a result, the court found that the trustee had not properly contested the notary's acknowledgement under Kentucky law. Consequently, the court concluded that the trustee could not void the bank's lien and affirmed the lower court's decision to grant summary judgment for New South and Honaker.

Finally, the court addressed New South's contention that, under Kentucky law, the Pelfreys' recorded mortgage provided constructive notice to a bona fide

purchaser regardless of whether Honaker's acknowledgement was valid. In 2006, section 382.270 of the Kentucky Revised Statutes was amended to stipulate that a recorded mortgage provides constructive notice to bona fide purchasers of the mortgage on the property despite a defective acknowledgement. Rejecting the trustee's assertion that the statute applied only to mortgages with defective acknowledgments recorded before the statute was amended, the court ruled that based on the language of the statute and the presumption that statutes operate prospectively, the statute applied to both mortgages recorded before the amendment and mortgages recorded after the amendment. Accordingly, the court ruled that as a bona fide purchaser the trustee could not void the Pelfreys' mortgage because the record of their mortgage provided constructive notice regardless of a defect in the acknowledgement.

The Sixth Circuit Bankruptcy Appellate Panel's ruling in this case protects lending institutions by preventing bona fide purchasers such as bankruptcy creditors from voiding recorded mortgages simply because the notary's appointment was technically deficient. More generally, the court's decision to validate the acknowledgements of de facto notaries saves contracting parties from the burden of ensuring that their chosen notary is a duly appointed notary when the notary reasonably appears to be a lawful notary. Although the court interpreted Kentucky statutes and case law to reach its decision, the case serves as a warning to area attorneys that the court will uphold a recorded mortgage, despite a deficiency in the notary's acknowledgement of the mortgage, when the contracting parties are not aware of the deficiency. In situations where the parties are aware of a deficiency in the notary's acknowledgement, the court may decline to uphold the mortgage. If any doubt as to the validity of the notary's appointment exists, attorneys representing mortgagors should instructor their clients to have the lending institution acknowledge the uncertainty in order to increase the probability that the mortgagors can later void the mortgage if desired. Attorneys representing lenders should advise their clients to avoid retaining notaries whose appointment could be called into question to avert potential litigation. Attorneys representing lenders should also instruct their clients to be vigilant during the mortgage recordation process to ensure that the mortgages they hold are properly recorded and are not subject to annulment by subsequent bona fide purchasers.

**In Delaware, non-corporate entities form a sealed contract simply by affixing the term "seal" next to the signature of a contracting party, even in the absence of intent to form a sealed contract in the body of the instrument.** *Whittington v. Dragon Group, L.L.C.*, 991 A.2d 1 (Del. 2009).

By Joshua McCord

In the state of Delaware, contracts under seal, or "specialty contracts," are distinguished from unsealed contracts, and the former are subject to a significantly longer statute of limitations period than the latter. Because of this temporal discrepancy, the issue of whether a contract is "sealed" is often debated vigorously, as its resolution could determine whether an action is immediately dismissed or will continue through the litigation process. While most states have enacted statutes to define what constitutes a contract under seal, the Delaware General Assembly has offered no guidance in this area, leaving the issue to be resolved by the state judiciary. Due largely to conflicting trial court decisions, however, the applicable rule governing the formation of a sealed contract in Delaware has long been ambiguous, particularly in regards to the demonstration of intent to form such a contract as a requirement for formation. In *Whittington v. Dragon Group, L.L.C.*, the Delaware Supreme Court clarified this issue by addressing, as a matter of first impression, the evidentiary standard required for the formation of a sealed instrument under Delaware law.

The facts leading to *Dragon Group* began in 2001, when Frank Whittington ("Frank") entered into an Agreement in Principle (the "AIP") with Dragon Group, L.L.C. (the "Dragon Group") in order to settle a series of various disputes between them. The AIP did not contain any reference to a seal other than the word "seal" printed next to each signature. While Frank interpreted the AIP to give him partial ownership rights to the Dragon Group, the remaining owners of the Dragon Group disagreed. In July 2006, after years of disputes regarding the ownership of the Dragon Group, Frank commenced this action in the Delaware Court of Chancery to enforce his ownership rights as specified in the AIP. The court of chancery proceeded, however, to dismiss Frank's action on the ground of laches.

For actions brought by a plaintiff in equity, only the doctrine of laches can bar a lawsuit on the basis of time. Statutes of limitations operate as a temporal bar to actions at law, but they do not automatically bar actions in equity. Unlike statutes of limitation, laches do not prescribe a specific time after which an action is barred in equity but instead bar an action where the plaintiff unfairly prejudices the defendant

by waiting an unreasonable length of time before bringing his lawsuit. In applying the doctrine of laches under ordinary circumstances, however, Delaware courts apply statutes of limitation analogously by using the time period specified by an action at law as a proxy for the time period during which a plaintiff can bring an analogous action in equity. Thus, under normal circumstances, if a statute of limitations bars a plaintiff's ability to bring a suit at law, it also bars his analogous remedy in equity. Under unusual or extraordinary circumstances, however, a court of equity will not be bound by the analogous legal remedy's statute of limitations and may even shorten the amount of time a plaintiff has to bring his claim relative to the time statutorily prescribed for the analogous legal remedy.

Under Delaware law, a plaintiff has a three-year statutory period during which he may bring a claim under an ordinary, unsealed contract, although this period of time is extended to twenty years when the instrument is "sealed." Unlike the majority of state legislatures, however, the Delaware General Assembly has failed to define the requirements for a contract to be formed under seal, which has left the issue to be resolved through judicial interpretation. Unfortunately, the case law is largely unhelpful in establishing a uniform test for the formation of a sealed contract, as the Delaware trial courts apply two conflicting rules in this area. Under the first rule, a contract is "sealed" as long the word "seal" is printed on the form next to the signature of one of the parties to the contract; if this condition is met, no consideration is given to whether the body of the instrument communicates intent to form a sealed contract. Conversely, the second, more rigid rule requires the body of the instrument itself to convey that the parties intended for it to be formed under seal.

In Frank's case, the court of chancery applied the more stringent of the conflicting tests and concluded that his contract with the Dragon Group was not under seal. Because the instrument between Frank and the Dragon Group was not a mortgage or a promissory note (two instruments which are typically sealed contracts), the court reasoned that Frank must meet a higher standard of proof by demonstrating intent to form a sealed instrument. The AIP between Frank and the Dragon Group only referred to a "seal" by printing it next to the signatures, thus the court of chancery held that Frank failed to meet the higher burden of demonstrating intent to form a sealed contract within the body of the instrument itself. As a result, the court of chancery applied the three-year statute of limitations by analogy and dismissed Frank's action on the ground of laches. Frank subsequently appealed to the Delaware Supreme Court.

On appeal, the Delaware Supreme Court opted for the simpler of the two rules and held that an individual creates a sealed contract simply by affixing the word "seal" next to the signature of a contracting party. As long as "seal" appears next to a signature, the contract is a specialty contract regardless of whether the parties communicated intent to create a sealed instrument. Thus, because Frank's contract with Dragon Group met this condition, it was "sealed," making the twenty-year statute of limitations period the applicable timeframe by way of analogy. Because the court of chancery barred Frank's claim by incorrectly applying the three-year statute of limitations, the Delaware Supreme Court remanded the case to the court of chancery with instructions to apply the twenty-year statute of limitations.

The Delaware Supreme Court's decision to adopt a uniform rule for the creation of a sealed contract serves to clarify an ambiguously defined distinction for non-corporate entities (as opposed to corporations, for whom the rule does not apply) and their transactional attorneys. In particular, this rule has practical implications for those who may want to take advantage of the discrepancy in the period of time available to file claims between a sealed and unsealed contract. Where an individual seeks a shorter time period under which claims may be filed under a contract, to reduce his exposure time to potential liability, for instance, his attorney should advise him to refrain from printing "seal" next to the signature blanks. Alternatively, where an individual seeks to maximize the length of time he will have available to file a potential claim, his attorney should advise him to include the "seal" language. Due to the adoption of this simple rule, transactional attorneys also have a reduced incentive to include any language relating to a seal in the body of the instrument, as it is irrelevant in the presence of the term "seal" beside an individual's signature. Transactional practitioners in every state must remain cognizant of subsequent legislative action affecting the formation of a sealed contract in Delaware, however, as a single statutory change could render the decision in *Dragon Group* irrelevant and authoritatively declare an alternative standard. But until the Delaware General Assembly takes such action, the judiciary has provided a simple, practical solution: if you want to form a sealed contract in the state of Delaware, simply ensure that "seal" is printed by your signature.

**In Tennessee, under a cost-plus construction contract, a contractor's failure to provide an accurate and detailed accounting of expenses, combined with the contractor's abandonment of the job site, results in a material breach of the contract.** *Forrest Constr. Co. v. Laughlin*, No. M2008-01566-COA-R3-CV, 2009 Tenn. App. LEXIS 829, 2009 WL 4723365 (Tenn. Ct. App. Dec. 9, 2009).

By William T. Smith

Cost-plus contracts differ from traditional set fee arrangements in that a contractor is reimbursed for his reasonable expenses—typically both overhead and actual net costs—and paid an additional fixed percentage fee as profit. In an uncertain economy, this type of agreement provides much-needed flexibility and accounts for the shifting demands of projects, materials, and plans.

In *Forrest Construction Co. v. Laughlin*, the Tennessee Court of Appeals interpreted the terms of a cost-plus construction contract to determine whether a homeowner materially breached the contract where (a) the contractor failed to provide an itemized accounting of costs under the contract's terms, and (b) the homeowner subsequently proposed an alternate plan of payment. The court of appeals reversed the trial court and found that the contractor, not the homeowner, materially breached the contract first. The court construed the contractor's obligation to provide an itemized accounting of costs as a condition precedent to the homeowner's duty to remit payment. Because the contractor did not produce satisfactory expense records, the homeowner's duty to pay was never triggered. The homeowner's proposal of an alternative plan of payment could not have been an anticipatory repudiation, and the contractor's abandonment of the job constituted the first material breach.

In *Laughlin*, James Laughlin contracted with the Forrest Construction Company ("Forrest") for the construction of a new home. The cost-plus contract, signed July 11, 2003, by Mr. Laughlin and Thomas Naive, owner and sole member of Forrest, specified that Forrest would receive its actual net costs, plus 7% overhead and an additional 8% profit to be calculated from all actual costs of the project. Using this formula, payments by Laughlin were to be rendered on a weekly basis.

Construction commenced, and on July 6, 2004, Forrest submitted a request for payment for its June work but discovered that the Laughlins' account lacked sufficient funds. With Mr. Laughlin's assurances, Forrest continued construction at a cost of $137,000. On September 3, 2004, at Mr. Laughlin's request for records of Forrest's expenses to date, Mr. Naive provided Mr. Laughlin with a two-foot tall box

of papers containing an assortment of checks, invoices, and receipts—some of which did not relate to the Laughlins' project. Mr. Laughlin subsequently requested a meeting with Mr. Naive. On September 10, the same day that Mr. Laughlin filed for an additional $145,000 loan from the bank, he and Mr. Naive met to discuss Mr. Laughlin's concerns with Forrest's recordkeeping. Though the exact sequence of events is disputed, at some point during their conversation, Mr. Laughlin proposed to pay $70,000 of the $87,000 of expenses that Forrest claimed, as well as an additional $50,000 to be paid directly to the workers to complete construction. At trial, Mr. Laughlin contended that Mr. Naive, though displeased, appeared to accept the proposal. Mr. Naive, however, visited his attorney directly after the meeting.

On September 13, 2004, Forrest filed a lien in the amount of $124,050.25 on the Laughlins' home. Mr. Laughlin discovered the lien when he attempted to release the funds he acquired from the loan on September 10. He subsequently contacted Mr. Naive, who never returned his call. Mr. Laughlin eventually hired another contractor to finish the project. This new contractor found numerous construction defects.

Forrest filed suit on December 8, 2004, claiming that the Laughlins breached the contract and that Forrest was entitled to compensation for the work performed under quantum meruit. Forrest sought to enforce the lien filed against the Laughlins' home. The Laughlins counterclaimed for breach of contract, unjust enrichment, negligent construction, gross negligence, negligence per se for violations of building codes, and Tennessee Consumer Protection Act violations.

The trial court found that Mr. Laughlin's refusal to pay Forrest by the contract terms amounted to a material breach; additionally, the court held Mrs. Laughlin liable for the value of all work performed under quantum meruit. Damages, including pre-judgment interest, totaled $134,521.88. However, the Laughlins succeeded in their negligent construction claims against Forrest. Although their Tennessee Consumer Protection Act claims failed and their attempt to pierce the corporate veil was deemed moot, the Laughlins received a judgment of $137,875.59. On balance, the trial court's decision left Forrest owing $3,335.71. Both parties appealed.

On appeal, the Tennessee Court of Appeals reversed the trial court and held that, in fact, Forrest had been first to breach the contract materially by submitting payment requests that were not supported by full and accurate records, as contractually required, and by failing to finish construction. The court affirmed the

trial court's final ruling that the Laughlins were entitled to damages for negligent construction, agreeing that the Laughlins owed no duty to Forrest to provide notice of defects or an opportunity to cure. It remanded the issue of damages to the trial court for clarification or recalculation and reinstated the possibility of piercing the corporate veil.

In reaching these conclusions, the court of appeals employed a de novo review of the contract to interpret the intent and respective obligations of the parties. Using the contract's language, the court determined that the Laughlins were required to pay the costs plus profit to Forrest as stipulated, but only upon the condition that Forrest submitted payment requests *supported fully by accurate records*. Thus, the court construed the provision that Forrest adequately support its draw requests as a condition precedent to Mr. Laughlin's payment.

This interpretation of the contract contradicted the trial court's finding that Mr. Laughlin had anticipatorily repudiated the contract by proposing an alternative plan of payment. Because the trial court did not make specific findings of fact as to whether Forrest's accountings were sufficient, the court examined the adequacy of Forrest's records under a preponderance standard, without a presumption of correctness, and found that Forrest's recordkeeping failed to satisfy Forrest's contractual obligations. Citing Louisiana law that established a duty of accurate and itemized accounting, the court emphasized that the records provided to Mr. Laughlin contained receipts from other jobs, that Forrest's draw requests did not contain itemized charges, and that the sample of records that Forrest did submit in its draw requests did not match the spreadsheet of costs offered at trial. The court concluded that, because Forrest failed to provide accurate accountings—a condition precedent—Mr. Laughlin's duty to remit payment was never established; therefore, Mr. Laughlin's insistence on alternate payment could not have been a breach.

Instead, the court determined that under the factors of section 241 of the Restatement (Second) of Contracts, Forrest materially breached the contract by leaving the site and by never completing the Laughlins' home. Under Tennessee law, Forrest's non-performance entitled the Laughlins, as homeowners, to the difference between the contract price and the cost of completing the project; however, as the Laughlins were not entitled to profit from Forrest's breach, Forrest was entitled to the reasonable costs of all work actually completed. Yet, as it also did with Forrest's quantum meruit claim against Mrs. Laughlin, the court found that Forrest's records failed to establish its expenses adequately, applied the principle that damages cannot be awarded without proof, and awarded Forrest nothing.

Lastly, because Forrest abandoned the job site and did not return Mr. Laughlin's phone call, the court held that the Laughlins had no duty to provide Forrest with notice of defects or an opportunity to cure them. The court cited case law, which established that abandonment of a job provides an exception to the general duty to inform of defects because it renders performance of the contract too unlikely. The court determined that this abandonment, combined with the substantial number and "unworkmanlike" nature of the defects, rendered it reasonable that the Laughlins hired another party to finish the job without notice to Forrest. In short, the court found that the Laughlins had a right to proceed without risking further injury.

On balance, *Laughlin* highlights an essential concern for parties to a cost-plus agreement: ensuring an accurate and detailed accounting of expenses. After all, both profit and overhead are typically calculated from this figure. Transactional attorneys representing both contractors and homeowners should draft contracts that specifically encourage precise recordkeeping, explicitly precondition performance, and provide detailed recitations of expectations and obligations. Attorneys for contractors must inform their clients that it is their burden to establish expenses adequately. They must urge contractors to build a substantial record that demonstrates that all costs submitted are reasonable and proper. In the event of conflict, a contractor may present this record to a homeowner or a court to corroborate costs and to avoid lengthy disputes or liability for abandonment of a job site.

Attorneys for homeowners must inform their clients that their duty to pay is contingent upon the contractor's submission of detailed and accurate expense reports. As a cost-plus contract is predicated upon a mutual understanding that the expenses submitted by a contractor are correct, a homeowner may justifiably seek assurances or further negotiations about costs. In short, proof of costs must precede payment. Therefore, *Laughlin* represents a minor victory for homeowners. *Laughlin* puts contractors on notice: They must establish expenses with accuracy and certainty.

## LABOR & EMPLOYMENT

**Where the firing of an employee occurs as part of a reduction in the employer's work force, the employee must provide additional evidence, other than an age differential, to establish a *prima facie* case of workplace age discrimination against the employer.** *Schoonmaker v. Spartan Graphics Leasing, LLC*, 595 F.3d 261 (6th Cir. 2010).

By Rachel Naomi Watson

The Age Discrimination in Employment Act (the "ADEA") allows employees to bring claims against employers when disparate treatment occurs in the workforce based upon their age. The age discrimination must be intentional, and where termination occurs as part of a work force reduction, the plaintiff must show additional evidence that indicates the employer "singled out the plaintiff for discharge for impermissible reasons." In *Schoonmaker v. Spartan Graphics Leasing, LLC*, the Sixth Circuit Court of Appeals looked at what type of evidence was "sufficiently probative" to indicate discrimination on the basis of age.

In *Schoonmaker*, managers at Spartan Graphics Leasing, LLC ("Spartan Graphics"), a screen-printing and offset printing company, evaluated their respective departments for cost-cutting measures in response to slow business. The finishing manager who ran the bindery department, Carl Pease, decided to cut costs by laying off two individuals from the third shift because it was the least productive of the three shifts in the workday.

Pease first laid off Bonnie Evert, age 65, stating he did so because she initially got the job as a favor after being let go in another department and citing her encroaching retirement at the end of the year. Pease then laid off Harriet Schoonmaker, age 58, testifying that he chose to release her instead of another employee because she was sometimes hard to work with. Pease indicated that the other employee, Melanie Taylor, would get along better with the other employees than Schoonmaker, emphasizing that "it's better to have people that can get along and work together and be more of a team." Pease also relied on his own observations that Taylor was more productive than Schoonmaker and would be a better team player.

Spartan Graphics had a written policy regarding staff reductions, but Pease admitted he was unaware of this policy. The policy stated that Spartan Graphics

would seek to identify and retain employees who were "most qualified . . . based on qualifications, productivity, attendance, general performance record and other factors" when faced with reduction in the size of the work force. When the factors enumerated in the manual were considered to be relatively equal among employees, the manual stated that termination decisions would be guided by the employees' length of service with the company. In his decision to terminate Schoonmaker, Pease did not consider Schoonmaker's longer period of employment with the company than Taylor's, nor that Taylor had been reprimanded for excessive absenteeism in 2005. Pease also did not review the personnel files of any of the third-shift workers while making this decision.

Schoonmaker brought suit against Spartan Graphics under the ADEA, claiming that she was released during the company's efforts at reduction in the workforce due to her age. Spartan Graphics then moved for summary judgment. The district court granted the motion for summary judgment, deciding that Schoonmaker had failed to establish a *prima facie* case of age discrimination in a work force reduction setting.

On appeal, the Sixth Circuit examined the elements of the *prima facie* case and upheld that Schoonmaker did not meet her burden of establishing a case in the context of a reduction in work force discrimination claim. The court further explored whether Spartan Graphic's termination decision implied pretext of age discrimination and found no evidence to give rise to this claim.

The crux of claims under the ADEA is whether the discrimination was intentional. A plaintiff may use circumstantial evidence to establish a *prima facie* case of disparate treatment, based on age, by demonstrating the four elements of the test established in *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973) (the "*McDonnell Douglas* test"): "1) that she was a member of a protected class; 2) that she was discharged; 3) that she was qualified for the position held; and 4) that she was replaced by someone outside of the protected class." In cases involving termination occurring as a result of workforce reduction, the fourth element is modified and requires additional "direct, circumstantial, or statistical evidence" indicating discriminatory discharge. The evidentiary burden is higher for workforce reduction cases because in these decisions the need to reduce the workforce is a legitimate reason for terminating employees. For purposes of the *McDonnell Douglas* test, an employee is not considered "replaced" when their work is redistributed among other employees or another employee is assigned to perform their work in addition to that employee's preexisting duties. Instead, "replacement" of a former employee occurs

when another employee is hired or reassigned to take over the former employee's duties. There must be evidence that is "sufficiently probative" to establish a discriminatory motive in the employee's termination, evincing for example, that the plaintiff possessed superior qualifications than a younger co-worker in the same position, or producing statements made by the employer that indicated a discriminatory motive.

The Sixth Circuit found that Schoonmaker's proffered evidence was not "sufficiently probative" to demonstrate discrimination based on age. The first three criteria of the *McDonnell Douglas* test were not at issue, but the fourth, whether Schoonmaker could provide probative evidence under the fourth modified criterion, was. The fact that a younger employee was retained instead of Schoonmaker was not in itself indicative of age discrimination because there was no evidence that Schoonmaker possessed qualifications greater than Taylor. According to Pease's testimony, reduction in workforce was the primary motive for the terminations. The court also determined that retaining a younger employee in this context was not sufficient to establish age discrimination but merely demonstrated an age differential between the employees in question, Schoonmaker and Taylor. That the two oldest employees were the ones terminated was also not probative of discrimination. The court did not constitute this as "additional evidence" of systematic discrimination because two workers represented such a small statistical sample. Schoonmaker's argument that Spartan Graphics failed to follow the guidelines for reducing their workforce in the employee manual was also not evidence supporting a claim of age discrimination. The court found that Pease, while ignorant of the handbook's policies, still followed its guidelines by comparing the "qualifications, productivity, attendance, general performance record," and other relevant factors in choosing between Schoonmaker and Taylor. The court reasoned that the totality of the evidence did not demonstrate age discrimination in the context of a reduction in force. The court also determined that Schoonmaker's arguments did not establish "pretext" to qualify as "additional evidence" to demonstrate a showing of age discrimination. The court concluded that Schoonmaker's evidence, taken separately and aggregately, was not indicative of targeted age discrimination.

The Sixth Circuit's decision that additional evidence, besides an age differential, is required to establish a *prima facie* case in a reduction-in-force setting has great impact because of today's economic environment and worker demographics. This decision is a practical one in light of today's job cutbacks; it shields employers from frivolous discrimination claims in their decision to reduce

their workforce in efforts to cut costs. In many cases, employees that are terminated are of more advanced ages, as the baby-boomer generation constitutes much of the workforce. With the increasing age of this generation, the trend of an older working population is only likely to continue in the future.

The unfortunate reality, that many of the people in these age groups are losing their jobs, is not grounds for discrimination claims on all fronts. The modification of the *McDonnell Douglas* test as applied in *Schoonmaker* requires a heightened level of evidence to differentiate between coincidental correlations in termination decisions and causational discrimination against someone in a protected class. The modification of the *McDonnell Douglas* test gives an extra buffer to employers for frivolous claims, while still providing an avenue through which employees with legitimate discrimination claims can present their evidence and find justice.

With guidance from the *Schoonmaker* decision, attorneys representing employees in discrimination claims should counsel their clients regarding the weight of evidence needed for a successful claim. In addition to proving the four elements of the *McDonnell Douglas* test, additional evidence is required for an employee to establish a *prima facie* case of age discrimination where the employee's termination occurred as part of a work force reduction.

Attorneys representing employers should advise the businesses in regard to termination practices. Evaluating reasons for terminating an employee before termination, to ensure age was not the driving factor, will shield employers from litigation regarding discriminatory termination practices. If employers fail to do this, they may be liable for any damages related to an employee's improper firing based on age.

## PROPERTY

**A chattel attached to land may be exempted from real property tax rates in Tennessee if the owner intends to remove the chattel at will or can remove the chattel without material harm to the land.** *Hermann Holtkamp Greenhouses, Inc. v. Metro. Nashville and Davidson County*, No. M2009-000345-COA-R3-CV, 2010 Tenn. Crim. App. LEXIS 77, 2010 WL 366697 (Tenn. Ct. App. Feb. 2, 2010).

By Luke Archer

Distinguishing between real property and personal property is not always easy. A house is clearly real property, while those baseball cards in the attic are perfect examples of personal property. But what about a picket fence in the front yard? Or that above ground swimming pool out back?

In *Hermann Holtkamp Greenhouses, Inc. v. Metropolitan Nashville and Davidson County*, the Tennessee Court of Appeals addressed the difference between real and personal property. The court decided whether certain commercial greenhouses were real property and, if so, whether they were exempted from the real property tax by virtue of being commercial equipment under section 67-5-501(2) of the Tennessee Code. The court first concluded that the greenhouses were real property because the owner intended for them to be permanently affixed to the land. The court then refused to classify the greenhouses as commercial equipment because they could not be moved without materially damaging the land. Although the holding in *Holtkamp Greenhouses* is limited to the specific greenhouses in the case, the decision offers valuable guidance to attorneys seeking to advise their clients on ways to lower their real property taxes.

Herman Holtkamp Greenhouses, Inc. ("Holtkamp Greenhouses") operates a botanical nursery in Davidson County, Tennessee. Between 1986 and 1989, Holtkamp Greenhouses covered one-third of its thirty-one acre spread with seven large greenhouses. The greenhouses were assembled on site, but their manner of construction differed from most buildings. Instead of being secured by an underground foundation, the greenhouses were anchored two feet into the ground with concrete posts. Bolted to the six-inch portion of the posts that protruded from the ground were metal poles. These poles formed the greenhouses' frames. After the frames were assembled, glass panels were installed.

After completing the basic structure of the greenhouses, Holtkamp Greenhouses made several improvements to them. The company covered most of the dirt floors with gravel and even installed concrete flooring in some places. Holtkamp Greenhouses also laid concrete paths, measuring about two feet wide and three inches thick, to run alongside the growing plants. To improve the growing environment, the company connected the greenhouses to gas, water, and electricity, thereby enabling the installation of boilers, a heating and cooling unit, and a sprinkler system. Lastly, to improve the working environment, Holtkamp Greenhouses used concrete blocks to install a locker room, a cafeteria, and restrooms, complete with indoor plumbing. In addition to these interior improvements, Holtkamp

Greenhouses also constructed a concrete tunnel to connect at least two of the greenhouses.

The Davidson County property assessor classified the greenhouses as real property rather than personal property. The assessor's decision nearly quadrupled the assessed use value of Holtkamp Greenhouses' real property. In 2001, Holtkamp Greenhouses challenged the assessor's classification in order to reduce its real property tax burden. The lawsuit wound its way through the administrative courts. The State Board of Equalization found that the greenhouses were personal property, but the Assessment Appeals Commission reversed, classifying the greenhouses as real property. Holtkamp Greenhouses then filed a petition for judicial review. The trial court granted summary judgment for the property assessor, concluding that the greenhouses were real property.

On appeal, Holtkamp Greenhouses contended that the trial court erred by classifying the greenhouses as real property. The company further argued that even if the greenhouses were real property, they still were exempted from the real property tax due to their status as commercial equipment under section 67-5-501(2) of the Tennessee Code. The Tennessee Court of Appeals rejected both claims.

First, the court of appeals concluded that the greenhouses were real property. In Tennessee, real property is defined under section 67-5-501(9)(A) of the Tennessee Code. The section states that "'[r]eal property' includes lands, tenements, hereditaments, structures, improvements, . . . or machinery and equipment affixed to realty . . . ." After reviewing the statute, the court narrowed its focus to whether the greenhouses were affixed to the land, thereby implicitly acknowledging that the greenhouses could be characterized as "machinery" or "equipment."

However, the court of appeals found the term "affixed" ambiguous. For guidance in determining what "affixed" meant, the court turned to the common law of fixtures—an approach that Tennessee courts had used before. The court explained that, under the common law, a fixture is not determined by the physical characteristics of the attached chattel but by the intent of its owner. If the owner intends for the attached chattel to be permanent, it is considered to be affixed to the land, but if the owner intends to be able to remove the chattel at his pleasure, it is considered to be separate property.

Using the common law of fixtures, the court of appeals decided that the greenhouses were machinery or equipment affixed to the land and therefore qualified as real property under section 67-5-501(9)(A). Although the company averred that it

did not intend for the greenhouses to be permanent, the court found otherwise. The court agreed with the trial court, which found that "it was 'unlikely' that an owner who intended for the greenhouses to be temporary would put in such amenities and would have the greenhouses in place 'for decades.'" In coming to this conclusion, the court relied on the greenhouses' size, amenities, and duration on the land, the connected utilities, and the fact that the company owned both the greenhouses and the land beneath them. The court acknowledged some evidence that Holtkamp Greenhouses intended for the greenhouses to be portable, such as the fact that they could be disassembled and moved at only twelve percent of the cost of purchasing new ones. Nevertheless, the court found this evidence was "outweighed" by evidence that the greenhouses were intended to be permanent

After concluding that the greenhouses were real property, the court then decided whether they fit within the commercial equipment exception under section 67-5-501(2). The section exempts, from the real property tax, commercial equipment that "can be detached without material injury to the real property." The court concluded that removing the greenhouses would materially harm the land beneath them and agreed with the trial court that moving the greenhouses "would not be easy." The court noted the complex's size (436,000 square feet), the utility connections, the tunnel, the concrete flooring, and the foundational posts as items whose removal would materially damage the land.

*Holtkamp Greenhouses* is a case with a narrow holding but lasting legal implications. While its "cut-and-paste" precedential value may be limited to commercial greenhouses, the decision reaffirms Tennessee's commitment to the common law of fixtures and provides a helpful application of the commercial equipment exemption to the real property tax. In doing so, the decision teaches valuable lessons to all attorneys hoping to lower their clients' real property taxes.

First, attorneys should help their clients identify chattels that toe the line between real and personal property. These items may include everything from fences, sheds, and above ground swimming pools to radio towers, construction equipment, and solar panels. Once these chattels are identified, attorneys should urge their clients to make them as portable and temporary as possible. The easier a chattel is to remove from the land and the shorter it has been there, the less likely a court will find that the chattel's owner intended for it to be permanently affixed to the land, thus avoiding the designation of real property and the higher tax rate.

Second, attorneys should urge their commercial and industrial clients to attach equipment to the land in such a way as to minimize its damage to the real property if removed. If removing the equipment does not materially damage the real property, the equipment, even if considered to be real property, will likely be exempted from the higher real property tax rate as commercial equipment under section 67-5-501(2) of the Tennessee Code. Therefore, attorneys should inform clients that even if they intend for commercial or industrial equipment to be permanently affixed to the land, ensuring that the equipment can be easily removed could save a pretty penny in real property taxes.

## REAL ESTATE

**Grandfather clause codified in section 13-7-208(b)(1) of the Tennessee Code is not applicable to an establishment that, although classified as a prior legal commercial use, is not in operation before a change in state, county or municipal zoning regulations.** *Smith County Reg'l Planning Comm'n v. Hiwassee Vill. Mobile Home Park, LLC*, 304 S.W.3d 302 (Tenn. 2010).

By Dorothea K. Thompson

Section 13-7-208(b)(1) of the Tennessee Code codifies a "grandfather clause" exemption to zoning restrictions that protects the continuing operation of an establishment rendered noncompliant with later-enacted zoning ordinances imposed by "any governmental agency of [Tennessee] or its political subdivisions." In accordance with this statutory provision, "any industrial, commercial or business establishment" is entitled to such grandfather clause protection, provided that the establishment in question was "in operation" prior to the change in zoning. The applicability of grandfather clause protection, therefore, turns on two preconditions: (1) whether the establishment at issue served a "prior conforming commercial use" and (ii) whether the establishment was in actual operation before the change in zoning regulations rendered the business "a nonconforming use." Both statutory requirements are questions of material fact and susceptible to contrary judicial interpretation.

In *Smith County Regional Planning Commission v. Hiwassee Village Mobile Home Park, LLC*, the Tennessee Supreme Court addressed whether a mobile home park constituted a commercial, as opposed to a residential, use and thus was eligible for

protection within the scope of section 13-7-208(b)(1) of the Tennessee Code. Additionally, the court determined whether the mobile home park at issue warranted protection under section 13-7-208(b)(1) based on its "actual operational status" at the time Smith County's Private Act was enacted, which rendered the park a nonconforming use.

The pertinent factual circumstances of this case began in 1997 when Ricky D. Sanders ("Sanders") acquired a 9.9-acre tract of property located along Hiwassee Road in Smith County, Tennessee. Sanders intended to use the land for the rental of mobile homes. Sanders testified that, despite his inquiries, members of the Smith County Regional Planning Commission (the "Planning Commission") never informed him of pre-existing regulations governing mobile home park development, namely a "1975 Resolution" requiring "a permit from the county building inspector or health inspector to establish or maintain a mobile home park" in Smith County. The facts indicate that during 1997 and 1998 Sanders took measures to construct a mobile home park on Hiwassee Road. Sanders installed septic tanks and procured the required certification for the sewage disposal system, obtained permits to establish electricity at the park, installed ten water taps, and purchased ten new mobile homes as well as four used mobile homes. According to Sanders's testimony, his first tenant moved into a mobile home around May 30, 1998, although this occurrence, as the court noted, was not substantiated by documentation or evidence of rent collection. The claimant in this case, Hiwassee Village Mobile Home Park, LLC ("Hiwassee LLC"), ultimately acquired the Hiwassee Road property in May 2006 after the property had been conveyed to two additional owners.

The Tennessee Legislature enacted 1998 Private Chapter Number 152 (the "Private Act"), which was initially proposed by the Planning Commission to regulate mobile home park development. The Private Act became effective on May 11, 1998—several weeks before Sanders's first tenant reportedly took up residence at the park. The Private Act makes it "'unlawful for any person to place or maintain three . . . or more mobile homes for living or sleeping purposes on any premises or tract of land in Smith County' outside specified municipalities without a permit." The facts state that the mobile home park on Hiwassee Road was not in compliance with the zoning restrictions of the Private Act. Accordingly, in 2002, the Planning Commission sued to enjoin the defendant-owners at the time from operating the mobile home park in violation of the county's Private Act. The trial court permitted the Planning Commission to amend its complaint by adding subsequent owners of

the property as defendants. Eventually, Hiwassee LLC remained as sole defendant in this litigation.

Following a bench trial, the trial court granted the Planning Commission injunctive relief against Hiwassee LLC. The trial court made two principal findings of fact. First, the court found that protection under the grandfather clause of section 13-7-208(b)(1) did not apply to the mobile home park "because the park was not in operation when the Private Act took effect." The trial court concluded that Sanders's efforts prior to the enactment of the Private Act constituted "mere preparation and intent" and thus were insufficient to establish the actual operation of the park. Second, the trial court found that the mobile home park had effectively been abandoned from 2002 to 2004.

On appeal, the Tennessee Court of Appeals arrived at the opposite conclusion, declaring that Sanders "had established a vested right to continue a pre-existing use" because his prior efforts represented the inception of the park's full operation. The court of appeals, however, affirmed the trial court's judgment on the basis that the preponderance of the evidence supported the trial court's finding of abandonment. Additionally, the appellate court classified the mobile home park as a residential use, making the park ineligible for protection under the grandfather clause.

On review, the Tennessee Supreme Court held (1) that the mobile home park was a commercial establishment as required for grandfather clause protection from a change in zoning law but (2) that the Hiwassee mobile home park was properly precluded from such protection because it was not in operation prior to the effective date of the Private Act. Applying the rules of statutory construction in its analysis, the court first construed the scope of section 13-7-208(b)(1)'s application by determining whether the meaning of the statute's reference to "any governmental agency of this state or its political subdivisions" was intended by the legislature to pertain to counties as well as municipalities. As noted by the court, the grandfather clause, at first glance, appears to have no application to county zoning, because its codification appears under the title, chapter, and part of the Tennessee Code that deals exclusively with municipal zoning. Adopting the reasoning of the Tennessee Court of Appeals in *Chadwell v. Knox County*, 980 S.W.2d 378, 382 (Tenn. Ct. App. 1998), the Tennessee Supreme Court embraced the more inclusive, plain meaning of the term "political subdivisions" and concluded that the grandfather clause applies to changes in county zoning regulations, thus abrogating earlier contrary interpretations advanced by the court of appeals in *Fields v. White*, No. 88-250-II, 1989 Tenn. App. LEXIS 64, 1989 WL 5456, at *2 (Tenn. Ct. App. Jan. 27, 1989) and *Riggs v. Burson*,

No. 03A01-90506-CV-00193, 1995 Tenn. App. LEXIS 697, 1995 WL 635748, at *3 (Tenn. Ct. App. Oct. 31, 1995).

The court next turned to the first issue *sub judice* of "whether a mobile home park is the kind of establishment amenable to grandfather clause protection." The court first examined the historical progression of cultural views on mobile home parks, noting that, until recently, legal commentators and most courts have characterized mobile home parks as commercial rather than as residential operations. Secondly, the court, arguing by analogy, emphasized its previous decision in the only case on point, *Clouse v. Cook*, No. 87-68-I, 1988 Tenn. LEXIS 72, 1988 WL 34834 (Tenn. Apr. 18, 1988), in which the court determined the Clouses' trailer park to be commercial in nature. In holding that the park in this case was of a commercial classification, the court clearly attributed great weight to Sanders's statement that he originally contemplated the mobile home park on Hiwassee Road as a business venture. In addition, the court pointed to the fact that the Planning Commission conceded to the operation of the Hiwassee mobile home park as commercial in nature.

With respect to the second issue under review, the court concluded that the evidence did not preponderate against the trial court's finding that the mobile home park was not in operation prior to the change in zoning regulations. As the court stressed, "[t]he grandfather clause is 'designed to protect ongoing business operations, not to extend the time allowed to develop a nonconforming business.'" The court emphasized several facts as important to its decision. First, Sanders testified that his first tenant moved onto the property after passage of the Private Act, and Hiwassee LLC introduced no evidence to corroborate Sanders's assertion of earlier lot rentals. Second, in violation of the 1975 Resolution, Sanders did not obtain "the necessary permits required for each mobile home." Finally, the court found that Hiwassee LLC failed to affirmatively show that Sanders had placed Smith County "on notice of his mobile home park operation."

The Tennessee Supreme Court's decision in *Smith County Regional Planning Commission* effectively expands the application of section 13-7-208(b)(1) to county zoning regulations and mobile home parks. Moreover, the court's rationale in dicta provides a needed elaboration of the "in operation" precondition, which, as the court announces, excludes such preparatory measures as acquiring "site plan approval" or a "business license." As this case demonstrates, it is incumbent upon landowners who intend to use their property for the development of a mobile home park or other business to ensure that their establishment complies with existing

zoning regulations or applicable pending legislation. In practice, transactional attorneys in Tennessee should counsel clients seeking grandfather clause protection that operational status requires supportive evidence that at the time the zoning law changed, the property at issue was dedicated to a prior permissible commercial use and that the appropriate regulatory authorities had notice of the business operation claimed.

## TAX

**Where a trust does not mandate generation-skipping transfers but merely permits such transfers pursuant to a general power of appointment, generation-skipping transfers initiated by the release, exercise, or lapse of the general power of appointment are subject to the generation-skipping transfer tax.** *Estate of Timken v. United States*, 601 F.3d 431 (6th Cir. 2010).

By Dan Calvert

Prior to the 1976 enactment of the generation-skipping transfer tax (the "GST tax"), transfers to persons two or more generations below the transferor were insulated from taxation. As a result, estate planners frequently employed generation-skipping transfers in place of outright transfers from one generation to the next. The GST tax eliminated this practice, but to prevent prejudice where transfers were irrevocable before the GST tax went into effect, Congress provided a grandfather clause disallowing the imposition of the tax in such circumstances. However, conflicting interpretations remained regarding the extent to which the grandfather exemption's scope encompassed transfers from trusts. In *Estate of Timken v. United States*, the United States Court of Appeals for the Sixth Circuit addressed the grandfather exemption's applicability to a trust that does not mandate a generation-skipping transfer but merely permits such a transfer at the discretion of the trustee.

In *Timken*, Henry H. Timken Jr. established a trust that became irrevocable upon his death in 1968. In accordance with the trust's terms, Mr. Timken's widow, Louise Blyth Timken, then received a general power of appointment over the trust assets for the stated purpose of paying the estate tax attributable to the inclusion of the trust in her estate. At the time of Ms. Timken's death in 1998, she had exercised her power of appointment only to the extent of directing that the trust assets be used for this purpose.

The trust stipulated that, following Ms. Timken's death, the remaining trust assets would be divided and placed in separate trusts for Mr. Timken's nieces and nephews and for the children of any deceased niece or nephew. Accordingly, the remaining trust assets were apportioned between Mr. Timken's five nieces and nephews, all of whom were alive at the time of Ms. Timken's death. Two nieces and one nephew made qualified disclaimers of their respective shares; these shares were subdivided and placed into separate trusts for their children, Mr. Timken's grandnieces and grandnephews. In 1999, the Estate of Louise Blyth Timken (the "Estate") received notice that it owed over $4 million of unpaid GST taxes.

Henry H. Timken Jr. Trust Fund A, together with the Estate and the nine sub-trusts created for the benefit of Mr. Timken's grandnieces and grandnephews, filed suit against the federal government contesting the Estate's liability for the GST taxes. In the district court, the parties stipulated to the relevant facts, and both acknowledged that the Estate was liable for the GST taxes unless the transfers at issue fell within the scope of the grandfather exemption. The parties filed cross-motions for summary judgment regarding this remaining issue, and the district court granted summary judgment in favor of the government. Because Ms. Timken had taken no action as to the monies at issue and the generation-skipping transfers occurred automatically, the transfers were deemed to have been pursuant to a lapse of her general power of appointment. Concluding that this lapse constituted a post-1985 transfer for purposes of the GST tax, the district court held that this transaction fell outside the scope of the grandfather exemption.

On appeal, the United States Court of Appeals for the Sixth Circuit affirmed the district court's judgment as well as its conclusions regarding the scope of the grandfather exemption. As amended in 1986, the exemption stipulates that the GST tax does not apply to "any generation-skipping transfer under a trust which was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after [this date]." The *Timken* court began by examining whether, in the context of lapses of a general power of appointment, the language "transfer under a trust" was sufficiently ambiguous to permit looking beyond its plain meaning. In concluding that it was ambiguous, the court cited its earlier holding in *Estate of Gerson v. Commissioner*, 507 F.3d 435 (6th Cir. 2007), that this language was ambiguous in the context of *exercises* of a general power of appointment. Addressing the exemption's scope for the first time in *Gerson*, the Sixth Circuit had rejected the functional distinctions between lapses of a general power of appointment, in the context of which other circuits had deemed "transfer

under a trust" ambiguous, and exercises of a general power of appointment, in the context of which some circuits had held that this language unambiguously excluded such exercises. Citing *Gerson*, the *Timken* court concluded that the functional similarities between exercises and lapses required that they be treated analogously and that the language "transfer under a trust" was similarly ambiguous in both circumstances. In light of this finding of ambiguity, the court concluded that the district court's examination of legislative intent was proper.

The Sixth Circuit then addressed the second question posed in *Timken*: whether the district court's construction of the grandfather exemption was reasonable. Pursuant to its inquiry into legislative intent, the district court looked to Treasury Department Regulations as indicators thereof and adopted the constructive additions provision, a treasury regulation stipulating that the portion of a trust subject to an appointment power's release, exercise, or lapse is treated as having been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. Evaluating the reasonableness of this construction, the Sixth Circuit again looked to its earlier decision in *Gerson*. The *Gerson* court had adopted a different regulatory amendment, which stipulated that the grandfather clause did not exempt transfers pursuant to the exercise, release, or lapse of a general power of appointment. Created after Ms. Timken's death, this regulation was thus unavailable to the *Timken* court. However, the *Timken* court concluded that the functional similarities between this regulation and the constructive additions provision, both treating a general power of appointment like outright ownership, necessitated the conclusion that the district court's adoption of the constructive additions provision was reasonable.

In response to the Estate's argument that application of the constructive additions provision to these circumstances was unreasonable, the court clarified the rationale for its holding. First, the court concluded that its construction of the grandfather exemption was not contrary to the exemption's goal of preventing prejudice. In light of the fact that the generation-skipping transfers herein occurred merely because of qualified disclaimers, the court found that the trust itself did not evidence any indication that Mr. Timken had relied on the prior tax-free status of such transfers, and even if he had, tax legislation did not create a vested right giving rise to a taxpayer's reasonable reliance. Second, the court determined that the 1986 amendment to the GST tax did not necessitate a narrower interpretation of the constructive additions regulation because the regulation's applicability was not tied to the grandfather exemption's effective date, the only aspect of the exemption altered

by the amendment. Finally, the court held that a contrary holding was not compelled by the possibility that application of the constructive additions provision herein would render the grandfather clause inapplicable whenever a pre-GST tax general power of appointment resulted in a post-GST tax generation skip. Rather, the court's holding directly served the GST tax's purpose of comparably taxing generation-skipping transfers and single-generation transfers.

Having thus established that application of the constructive additions regulation was reasonable, the court concluded by clarifying that the circumstances of the case fell within the scope of the regulation. The court found that the regulation applies when a portion of a trust remains in the trust after the post-September 25, 1985 release, exercise, or lapse of a power of appointment over that portion and the release, exercise, or lapse is treated as a taxable transfer. The circumstances herein fulfilled both of these requirements. Responding to the Estate's attempt to distinguish its case from illustrations accompanying the regulation, the court clarified that September 25, 1985, is the only date relevant to the exemption's application and whether the trustor was alive or dead on that date is immaterial. The court also denied the Estate's other attempts to distinguish this case and held that the exemption applies uniformly regardless of whether or not the transfer recipient was the trustor's actual grandchild and whether or not the power of appointment was granted pursuant to a marital deduction.

The Sixth Circuit's holding in *Timken*, though not expressly applicable to post-GST trusts and transfers thereunder, nevertheless merits careful consideration. First, estate planners should note the ramifications of the court's adoption of the comparative additions regulation. The court's holding might make trusts granting a general power of appointment especially valuable in light of the 2010 lapse of the GST tax. Had Mr. Timken died in 2010, any post-2010 generation-skipping transfers to his grandnieces and nephews would theoretically be exempt from a revived GST tax containing the same provisions. Because the termination of his interest was not taxable, the GST tax would not apply. However, such a conclusion is entirely speculative since Congress may apply a revived GST tax retroactively.

Second, transferors in other circuits should consider that precedent contrary to the *Timken* holding might be overruled in light of recent treasury regulations. The Eighth and Ninth Circuits have held that the grandfather clause exempts from GST taxation post-1985 transfers pursuant to *exercises* of general powers of appointment. However, the courts therein applied a version of the constructive additions provision not yet finalized and created prior to the 1999 regulation applied in *Gerson*. If, as the

*Gerson* court suggested, these Eighth and Ninth Circuit holdings are attributable to the then-provisional nature of the constructive additions regulation, these courts may hereafter overrule these holdings in light of the now-finalized constructive additions regulation and the 1999 regulation functioning similarly.